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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1963

No. [redacted] 113

JOSEPH M. THOMAS and JILL G. THOMAS,
Petitioners,

vs.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI
to the United States Court of Appeals for the Ninth Circuit.

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PETITION FOR A WRIT OF CERTIORARI
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for the Ninth Circuit.

The Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit entered in the above case on March 12, 1964.

OPINIONS BELOW

The Memorandum and Order of the United States District Court for the Southern District of California,

Northern Division, deciding in favor of the Petitioners herein, is printed in full on pages 36 to 39 of the Transcript of Record and is reported at 205 F. Supp. 194, 9 A.F.T.R. 1416. The Findings of Fact, Conclusions of Law and Judgment of the District Court are printed in full on pages 44 to 53 of the Transcript of Record but are not officially reported.

The opinion of the Court of Appeals for the Ninth Circuit reversing the judgment of the District Court is printed in full on pages 117 to 135 of the Transcript of Record and is reported at 329 F.(2d) 119, 13 A.F.T.R. 949.

JURISDICTION

The Judgment of the Court of Appeals for the Ninth Circuit was dated and entered on March 12, 1964. (R. 117-135.) A petition for rehearing was filed on April 1, 1964 and the Order Denying the Petition for Rehearing was made on April 14, 1964. (R. 137.)

The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1).

QUESTIONS PRESENTED

This case involves Petitioners' federal income tax liability for the years 1953 and 1954.

During the years at issue Petitioner, Joseph M. Thomas, and several other parties including Richfield Oil Corporation and Hancock Oil Company were

joint owners of the operating interest under an oil and gas lease. Under agreements executed by the oil companies and Quality Oil Company, petitioner's predecessor, the oil companies were given the exclusive right to develop and operate the properties and were required to advance, in the first instance, the costs of development and operation. Petitioner, Joseph M. Thomas, was liable for his pro-rata share of all development and operating costs but his personal liability was limited to the value of his share of the oil and gas produced.

During the years at issue the proceeds from the oil and gas produced greatly exceeded the costs of development and operation and the same was true for prior years.

Richfield purchased petitioner's share of the oil and accounted to him for the full purchase price but remitted to him the net amount remaining after deduction of petitioner's share of the expenses.

In the oil industry an interest of the type held by petitioner is commonly referred to as a "carried interest" with petitioner being the "carried party" and the oil company being the "carrying party".

The question presented is whether the *gross income* of the carried party (petitioner) from the property for the purpose of computing the allowance for depletion under Section 114 of the Internal Revenue Code of 1939 (26 U.S.C. 1952 Ed. Sec. 114) and Section 613 of the Internal Revenue Code of 1954 (26 U.S.C. 1958 Ed. Sec. 611) is the price for which

the carried party's share of the oil was sold or the net amount remitted to the carried party after deduction of his share of the expenses.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

Section 23 (26 U.S.C. 1952 Ed. Sec. 23);
Section 114 (26 U.S.C. 1952 Ed. Sec. 114).

Internal Revenue Code of 1954:

Section 611 (26 U.S.C. 1958 Ed. Sec. 611);
Section 613 (26 U.S.C. 1958 Ed. Sec. 613).

Treasury Regulations on Income Tax (1954 Code):

Section 1.613-3.

The pertinent parts of the above Statutes and Regulations are set forth in the Appendix hereto.

STATEMENT OF THE CASE

1. Basis for federal jurisdiction in the court of first instance.

As this is an action for the recovery of federal income taxes for the years 1953 and 1954 which were paid to the District Director of Internal Revenue at Los Angeles, California, jurisdiction was conferred upon the District Court by Title 28 U.S.C. Section 1346(a)(1). Jurisdiction was conferred upon the Court of Appeals for the Ninth Circuit by Title 28 U.S.C., Section 1291.

2. Summary of Facts.

The facts are not in dispute and are contained in the Stipulation of Facts (R. 24) filed with the District Court and the exhibits received in evidence at the trial. The basic facts are set forth in the Findings of Fact of the District Court (R. 45-51) and may be briefly summarized as follows:

Taxpayers are husband and wife and filed joint income tax returns for the years 1953 and 1954, the years involved in this action. (R. 24, 25.) As Jill G. Thomas is a party hereto solely because joint returns were filed, the word "taxpayer" when used herein in the singular, will refer to Joseph M. Thomas.

In 1948, Quality Oil Company (hereinafter referred to as Quality) was sublessee under certain oil and gas leases and owned the exclusive right to the oil, gas and other hydrocarbon substances in the property, subject only to the payment of royalties to the land owners and other parties having royalty interests therein. (R. 25, 45.)

On March 17, 1948, Quality made a partial assignment to Richfield Oil Company of 70% of its interest under said subleases as to a portion of the property included in the subleases. (R. 25, 45; Ex. 4.) On the same date, Quality and Richfield entered into an agreement entitled "Operating Agreement (Carried Interest)" (Ex. 5) with regard to the development and operation of the properties which were jointly owned by them as the result of the above assignment. (R. 26, 45.) On April 29, 1948, Quality made another partial assignment to Richfield of 70% of its interest in an

additional portion of the property subject to the subleases, and on the same date, the Operating Agreement was amended to make it apply to the additional interest. (R. 26, 46; Exs. 6 and 7.)

Under the terms of the Operating Agreement, Richfield was given the sole and exclusive right to explore, develop and operate the joint lands as a unit and was required, in the first instance, to pay all joint expense and charge the same to the joint account. All revenues were to be credited to the joint account and Quality was required to pay 30% thereof but was not personally liable for joint expenses other than to the extent of its interest in the gross revenues. (Ex. 5, pars. 2 to 6.)

On July 30, 1948, Quality made a similar partial assignment of 50% of its interest in another portion of the properties, to Hancock Oil Company (Ex. 8), except that Quality also reserved a 23½% over-riding royalty, and entered into a similar Operating Agreement with Hancock (Ex. 9). Under said Operating Agreement, Hancock was required to advance all costs for exploration, development and operations and Quality was required to pay 50% thereof but only out of its share of the oil and gas produced and saved. (R. 26, 46, and Ex. 9.)

On June 20, 1949, Quality and Hancock entered into a Supplemental Agreement with regard to their respective interests in the property being operated by Hancock, which agreement provided:

> "Each of the parties hereto is the owner of an undivided one-half of all oil and gas produced

and saved from the joint lands and, subject only to said right of Richfield Oil Corporation to purchase all of the oil and gas produced from said joint lands as hereinabove mentioned, each of the parties hereto has the full right to sell or otherwise dispose of its said one-half of all such oil and gas so produced and saved and Hancock has no representative authority or capacity to sell or market Quality's one-half share of any part of the oil, gas or other hydrocarbon substances produced from the joint lands." (R. 27, 47 and Ex. 10, para. 1.)

On October 25, 1949, Quality transferred and assigned to Joseph M. Thomas one-third of its interest under the subleases and one-third of its interests under the above-mentioned agreements with Richfield and Hancock. Similar assignments were made to other parties and Quality retained a one-third interest. (R. 27, 47 and Ex. 11.)

On December 30, 1949, Richfield entered into a written agreement with Quality, Joseph M. Thomas, and the other parties having an interest in the property being operated by Richfield, in which it was agreed that Quality and the individuals, as a group, owned a 30% interest and Richfield owned a 70% interest in the leases and the oil and gas saved therefrom. (R. 28 and 48.) Said agreement provided, among other things, as follows:

"Quality is the owner of an undivided 30% and Richfield is the owner of an undivided 70% of the lessee's interest under, and the leasehold estates created by, the oil and gas leases described in said

operating agreement hereinafter referred to as 'said leases', insofar as said leases cover the lands described in said operating agreement and therein and hereafter referred to as 'joint lands' and in the oil, gas and other hydrocarbon substances produced and saved from the joint lands under said leases; . . . and each of the parties hereto has the full right to sell or otherwise dispose of its respective share of all oil, gas and/or other hydrocarbon substances produced and saved from the joint lands under said leases and said operatting agreement . . . and Richfield has no representative authority or capacity under said Operating Agreement to sell, mortgage or otherwise dispose of Quality's 30% share of the oil, gas or other hydrocarbon substances produced and saved from the joint lands under said leases and said Operating Agreement, . . ." (Ex. 12, Para 1.)

Richfield and Hancock proceeded with the exploration and development of said properties and discovered oil in paying quantities. The oil produced was more than sufficient to pay all exploration and development costs and operating expenses. (R. 28, 30, 33 and 46.)

The above-described joint ownership of oil and gas rights under said subleases and operating agreements with Richfield and Hancock remained in full force and effect through the years 1953 and 1954 and Joseph M. Thomas owned a 10% interest in the properties which were operated by Richfield and owned a one-sixth interest in the properties which were operated by Hancock. (R. 28 and 48.)

During the years 1953 and 1954, the gross proceeds and expenses of the properties were as follows:

Property operated by Richfield	1953	1954
Gross proceeds	$3,162,024.62	$2,778,747.33
Landowner royalties	521,733.96	458,493.18
Gross proceeds after landowner royalties	$2,640,290.66	$2,320,254.15
Net expenditures for development and operating expenses	$ 287,307.58	$ 359,752.36
Total net proceeds from operations	$2,352,983.08	$1,960,501.79
Cash distribution to Thomas	235,298.07	196,049.99
Property operated by Hancock		
Gross proceeds	$ 597,017.95	$ 550,523.43
Landowner royalties	238,807.20	220,209.38
Gross proceeds after landowner royalties	$ 358,210.75	$ 330,314.05
Net expenditures for development and operating expenses	$ 61,269.94	$ 72,164.25
Total net proceeds from operations	$ 296,940.81	$ 258,149.80
Cash distribution to Thomas	49,490.12	43,024.95

(R. 29, 30, 31, 35 and 49.)

In their income tax returns for the years 1953 and 1954, taxpayers erroneously based their computation of depletion upon the cash actually distributed to them. (R. 33, 34 and 50.)

Within the time allowed by law, taxpayers filed claims for refund for overpayments of income taxes for the years 1953 and 1954 and claimed therein additional deductions for depletion based upon tax-

payer's pro-rata share of the gross proceeds after deduction of landowner royalties. (R. 34, 50.)

The District Court sustained taxpayers' contentions and rendered judgment for taxpayers for the recovery of the overpayments of income taxes for the years 1953 and 1954. (R. 44, 52.)

Respondent appealed and the Court of Appeals for the Ninth Circuit conceded that petitioners' contentions are supported by its own decision in *Helvering v. Armstrong,* 69 F(2d) 370, (9th Cir. 1934) and by *Reynolds v. McMurray,* 60 F(2d) 843, (10th Cir. 1932); *T. K. Harris Company v. Commissioner,* 112 F(2d) 76. (6th Cir. 1940); and *Commissioner v. J. S. Abercrombie Co.,* 162 F(2d) 338, (5th Cir. 1947), then overruled its own decision in *Helvering v. Armstrong* (supra), refused to follow the other decisions and reversed the decision of the District Court. (329 F(2d) 119, 131.)

REASONS FOR ALLOWANCE OF THE WRIT

1. THE DECISION OF THE COURT OF APPEALS IS IN DIRECT CONFLICT WITH DECISIONS OF THE COURT OF APPEALS OF THE TENTH CIRCUIT, THE FIFTH CIRCUIT AND THE SIXTH CIRCUIT.

The basic question involved in this appeal, namely, whether, under a carried interest arrangement, the portion of the gross income applied in payment of the carried party's share of the development and operating costs constitutes gross income to the carried party or to the carrying party, was first considered in 1932 by the Court of Appeals for the Tenth Circuit in *Reynolds v. McMurray,* 60 F(2d) 843, cert. den. 287 U.S. 664. In that case the Court of Appeals held that the carried party was taxable upon his full pro-rata share of the gross income from the sale of oil even though the costs of development and operating expenses exceeded the gross income and the carried party did not receive any payments.

Reynolds v. McMurray (supra) was followed by the Court of Appeals for the Ninth Circuit in *Helvering v. Armstrong,* 69 F(2d) 370 (1934) which involved another carried party under the same contract as that involved in *Reynolds v. McMurray.*

Reynolds v. McMurray (supra) was followed by the Court of Appeals for the Sixth Circuit in 1940 in *T. K. Harris Co. v. Commissioner,* 112 F(2d) 76.

The principle of *Reynolds v. McMurray* (supra) was applied by the Court of Appeals for the Fifth Circuit in 1947 in *Commissioner v. J. S. Abercrombie Co.* 162 F(2d) 338. In that case the Court of Appeals

affirmed the decision of the Tax Court which had held that the carried party's share of the gross income was not taxable to the carrying party even though the costs and expenses exceeded the gross income and no payments were made to the carried party.*

The principle of *Reynolds v. McMurray* (supra) and *Commissioner v. J. S. Abercrombie Co.* (supra) was also applied by the Court of Appeals for the Fifth Circuit in 1959 in *Prater v. Commissioner*, 273 F(2d) 124 and in 1962 in *Sowell v. Commissioner*, 302 F(2d) 177.

Prior to the decision of the Court of Appeals for the Ninth Circuit in the present case there was no contrary decision on comparable facts. In its opinion in the present case, the Court of Appeals concedes that the cases cited above support petitioners' contentions (R. 134, 329 F(2d) 119, 131) and expressly overrules its prior decision in *Helvering v. Armstrong* (supra).

The decision of the Court of Appeals in the present case is clearly and admittedly in direct conflict with the above cited decisions of the Courts of Appeals for the Tenth, Sixth and Fifth Circuits.

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*The Commissioner originally non-acquiesced in *J. S. Abercrombie Co. v. Commissioner*, 7 T.C. 120 (1946—2 Cum. Bull. 6). In 1949 the Commissioner withdrew his non-acquiescence and acquiesced in the Tax Court decision (1949—1 Cum. Bull. 1). In 1963 the acquiescence was withdrawn and the non-acquiescence was in effect reinstated (1963—1 Cum. Bull. 5).

2. THIS CASE INVOLVES AN IMPORTANT QUESTION OF FEDERAL LAW WHICH HAS NOT BEEN, BUT SHOULD BE, SETTLED BY THIS COURT.

Carried interest arrangements such as that involved in the present case are quite common in the oil industry and the determination of the gross income of the respective parties for depletion purposes is extremely important not only to the parties directly involved but also to the Internal Revenue Service. Unless the present conflict between the decision in the present case and the decisions of the other Courts of Appeals is resolved by this Court, in cases in which the carried party is in one circuit and the carrying party is in another circuit both parties might be allowed depletion upon the same gross income or both parties might be denied depletion.

The importance of the question to the oil industry is clearly evidenced by the fact that an amici curiae brief opposing petitioners' contentions was filed in the Court of Appeals by Richfield Oil Corporation, Signal Oil and Gas Company, Mobil Oil Company, Standard Oil Company of California, Tidewater Oil Company and Union Oil Company of California. The petition for certiorari in *Reynolds v. McMurray* was denied (287 U.S. 664) and the question involved has never been considered by this Court. The conflict created by the decision of the Court of Appeals in the present case is certain to generate extensive litigation which ultimately must be settled by this Court unless all the other circuits which have passed upon this question follow the lead of the Ninth Circuit and overrule their prior decisions.

It is respectfully submitted that the decision of the Circuit Court herein has admittedly created a conflict with the decisions of the other Courts of Appeals and that the question involved is of sufficient importance to numerous taxpayers and to the administration of the Internal Revenue laws that it should be settled by this Court.

Dated: May, 1964
San Francisco, California

Respectfully submitted,
BAYLEY KOHLMEIER,
Attorney for Petitioners.

(Appendices A and B Follow)

Appendix A

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the

pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

* * * * *

(26 U.S.C. 1952 ed., Sec. 23.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basic for Depletion.*—

(3) *Percentage depletion for oil and gas wells.* In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph.

* * * * *

(26 U.S.C. 1952 ed., Sec. 114.)

Internal Revenue Code of 1954:

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) *General Rule.*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, ac-

cording to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. For purposes of this part, the term "mines" includes deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613 (c). In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

* * * * *

(26 U.S.C. 1958 ed., Sec. 611.)

SEC. 613. PERCENTAGE DEPLETION.

(a) *General Rule.*—In the case of mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

(b) *Percentage Depletion Rates.*—The mines, wells, and other natural deposits, and the per-

centages, referred to in subsection (a) are as follows:

(1) 27½ percent—oil and gas wells.

(c) *Definition of Gross Income from Property*—For purposes of this section—

(1) *Gross income from the property.*—The term "gross income from the property" means, in the case of a property other than an oil or gas well, the gross income from mining.

* * * * *

(26 U.S.C. 1958, ed., Sec. 613.)

Treasury Regulations on Income Tax (1954 Code):

Sec. 1.613-3. *Gross Income From The Property.*

(a) *Oil and gas wells.* In the case of oil and gas wells, "gross income from the property", as used in section 613(c)(1) means the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well. If the oil or gas is not sold on the premises but is manufactured or converted into a refined product prior to sale, or is transported from the premises prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price of the oil or gas before conversion or transportation.

* * * * *

Appendix B

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

UNITED STATES OF AMERICA, *Appellant,* vs. JOSEPH M. THOMAS and JILL G. THOMAS, *Appellees.*	No. 18,306

[March 12, 1964]

On Appeal from the United States District Court for the Southern District of California, Northern Division.

Before: CHAMBERS, BARNES, HAMLEY, JERTBERG, MERRILL, KOELSCH, BROWNING and DUNIWAY, Circuit Judges.

JERTBERG, Circuit Judge:

On their joint Federal Income Tax Returns for the calendar years 1953 and 1954, appellees, who report their income on the cash receipts and disbursements method, computed their deductions for percentage depletion on the basis of the net amounts received by them from the operators of certain oil and gas properties. Appellees timely filed claims for refunds for overpayments and claimed therein that they were entitled to compute percentage depletion on the basis of a share in the gross income from the oil and gas operations. The claims were rejected by the Commissioner. Appellees filed a timely suit in the District Court to recover such claimed overpayments. Following trial, judgment was entered in their favor.

The broad question presented on the appeal is the amount which the appellees are entitled to use as a base for computing the percentage depletion.

Through a series of assignments of interests in oil and gas leases and subleases, and operating agreements held by Quality Oil Company, hereinafter "Quality", appellees on October 25, 1949 acquired an undivided ten percent (10%) in the subleases held by Quality and Richfield Oil Corporation, hereinafter "Richfield", and an undivided one-sixth (1/6) interest in subleases held by Quality and Hancock Oil Company of California, hereinafter "Hancock".

The interests which appellees acquired arose in the following manner:

In 1948, Quality was sublessee under certain oil and gas leases and owned the exclusive right to the oil, gas and other hydrocarbon substances in the property described in the oil and gas leases, subject only to the payment of royalties to the landowners and other parties having royalty interests therein. On March 17, 1948, Quality entered into two contemporaneous agreements with Richfield relating to a specified portion of the land under its sublease. Under one of the agreements, entitled "PARTIAL ASSIGNMENT OF OIL AND GAS LEASES", Quality assigned to Richfield an undivided 70% "of all • • • [its] right title and interest • • • in and to" the two subleases and "in and to the estates created by said leases" as to part of the land specified. The partial assignment stated that Quality retained an undivided 30% "in and to" the subleases; that royalties and other sums of money "with respect to the interest of assignor and assignee in said leases" relating to the part of the land covered by the agreement were to be paid in accordance with an "operating agreement" made and entered into concurrently with the assignment.

Paragraphs 4 and 6 of the assignment read as follows:

> "4. All geological, exploratory, drilling, operating and producing operations, and all other operations with respect to the hereinabove described lands, shall, notwithstanding the separate ownership by Assignor and Assignee of undivided interests in said leases, be conducted as an entirety and as the operation of one lessee, all in accordance with terms and conditions of said operating agreement hereinabove mentioned."

"6. Neither Assignor nor Assignee shall hereafter sell, assign, transfer, convey, quitclaim or otherwise dispose of any interest in said leases, or either of them, or in the lands leased thereby or in the estates created thereby, without the written consent of the other party hereto, except in accordance with the terms and conditions of said operating agreement hereinabove mentioned."

The operating agreement entitled "OPERATING AGREEMENT (carried interest)" referred to the partial assignment by Quality of an undivided 70% leasehold interest to Richfield and recited that Richfield "is an operating company, experienced in the development and operation of oil and gas properties, and it is desirable for the parties hereto to enter into this operating agreement because of the ownership by each party hereto of an undivided interest in and to said leases in so far as they affect said joint lands." Under paragraph 1 of the agreement, Richfield was designated as the "operator" of the joint lands and was given, for the purposes of this agreement,

"the sole and exclusive right to explore for, drill for, operate for, develop, produce, save, process and/or market oil, gas, and other hydrocarbon substances in, under or recoverable from said joint lands, and to extract and/or manufacture products therefrom during the term of this operating agreement, or any renewal or extension hereof, and Richfield, as such Operator, shall conduct and manage the operation of the joint lands for the exploration, discovery, development, and production thereon and therefrom of oil, gas, and other hydrocarbon substances under the terms and conditions of said leases and this agreement."

Richfield was required to commence drilling operations within six months or in lieu thereof Richfield could terminate the operating agreement and reassign or quitclaim all of its right and interest in and to the joint lands. Richfield was required to maintain a "joint account" which meant "the accounting to be maintained by Richfield as operator hereunder, for the purpose of recording all joint expenses, transfers, revenues, income and other transactions pertaining to the joint lands and the

operations thereof, and for the purpose of maintaining records and rendering statements to the parties hereto and settling accounts between them."

In the "joint account" Richfield was to record the gross revenues from operations, except for royalties payable to other parties; Richfield was also to record in the "joint account" and as "joint expense" the costs and expenses of every nature including all costs of exploration, discovery, drilling, developing, equipping, operating and maintaining the property, and of producing and marketing oil and gas obtained therefrom, as well as all other charges and liabilities, including the sum of $40,000 paid by Richfield to Quality for the assignment by Quality to Richfield of the interest in joint lands, "and the parties shall share therein and pay therefor in the proportion of 70% by Richfield and 30% by Quality." The operating agreement provided more detailed accounting procedures in Exhibit "A" attached to the agreement.

Paragraphs 6, 7, 9, 12, 13, 16, 22 and 24 of the agreement provide:

> "6. Richfield, as Operator hereunder, shall, in the first instance, pay all joint expense and shall charge the same to the joint account between Richfield and Quality as joint expense. Richfield, as Operator hereunder, shall credit all gross revenues from operations hereunder to the joint account. Quality shall not be personally liable for joint expense other than to the extent of its interest in gross revenues, and Richfield, as Operator, shall reimburse itself for joint expense solely from the joint account and the gross revenues therein, and may recover all joint expense to the extent that joint expense can be recovered from gross revenues by crediting to the joint account all such gross revenues. No net proceeds shall accrue during any calendar month until the joint account has been reimbursed for all net deficits for the current and preceding calendar months from gross revenues credited to the joint account, and until Richfield, as Operator hereunder, has been fully reimbursed for all joint expense theretofore charged to the joint account."

"7. Richfield, as Operator hereunder, shall credit to the joint account, as joint income, the gross revenues from operations hereunder, consisting of the gross proceeds from the sale of all oil and gas sold by Richfield, as Operator hereunder, and the market value, as hereinafter defined, of all oil and gas not sold but taken by Richfield for its own use, except as provided in paragraph 10 hereof, and except royalties taken by parties other than the parties hereto or paid in kind to parties other than the parties hereto, and the gross proceeds from any sundry sale or service rendered by Richfield, as Operator hereunder, for the benefit of joint operations."

"9. The excess, if any, of gross revenues, over and above all joint expense of operations hereunder, shall be the 'net proceeds' from operations hereunder, and the excess, if any, of all such joint expense, over and above gross revenues shall be the 'net deficit' from such operations, and if, as, and when net proceeds shall accrue, then Richfield shall be entitled to receive seventy (70) per cent thereof and Quality shall be entitled to receive thirty (30) per cent thereof, except that Richfield, as Operator hereunder, shall deduct from Quality's thirty (30) per cent of net proceeds and retain for its own use hereunder the accumulated interest charges referred to in paragraph 12 hereof, and shall also be entitled to establish, retain, maintain, and deduct from Quality's thirty (30) per cent of said net proceeds a reserve operating fund of $25,000. Richfield, as Operator hereunder, shall pay to Quality, in cash, on or before the last day of each succeeding calendar month, Quality's remaining portion of Quality's thirty (30) per cent share in the net proceeds accrued in the joint account from operations hereunder, to the end of the preceding calendar month and not theretofore paid, and the remaining seventy (70) per cent of such net proceeds shall be the share belonging to and shall be paid to or retained by Richfield hereunder."

"12. Richfield, as Operator, shall charge Quality interest on thirty (30) per cent of the net deficit in the joint account, as shown by the monthly statements herein elsewhere referred to, at the rate of four (4) per cent per annum, such

interest to be recovered by Richfield, as Operator, only from Quality's thirty (30) per cent of the net proceeds due to Quality hereunder if, as, and when such net proceeds shall accrue."

"13. Richfield, as Operator hereunder, shall have the sole and exclusive right and privilege of exercising any and all rights necessary or convenient for the exploration, discovery, development, production or operation for oil or gas on the joint lands, and Operator shall have full control and management of all exploration, discovery, development, production, processing, marketing, transportation and other operations in and on the joint lands, with the full power to do whatever, in its exclusive judgment, may be reasonably necessary or expedient therefor. Richfield, as Operator hereunder, shall not be required to drill any well or wells or to conduct any operations on the joint lands, but Richfield, as Operator hereunder, subject always, however, to the right of Richfield to terminate this agreement and quitclaim and/or reassign to Quality its interest in said leases at any time, as to all or any part of said joint lands, thereby relieving itself of all obligations under said leases and under this operating agreement as to said joint lands, or the portion thereof so quitclaimed and/or reassigned, shall drill such wells and conduct such operations on said joint lands as may be required by said Norris lease and/or said O'Day lease in order to maintain said leases in effect with respect to said joint lands. Quality agrees to drill such wells and conduct such drilling and development operations on the portions of the lands leased by said Norris lease and said O'Day lease, which are not included in said joint lands, as may be required by said leases in order to maintain said leases in full force and effect, and upon failure of Quality so to do, after twenty (20) days' written notice from Richfield so to do, said lands shall, at the option of Richfield, be included under this operating agreement as joint lands, and Richfield, as Operator hereunder, may drill such wells and conduct such drilling and development operations thereon as it may elect to do under this operating agreement. In such event, Quality shall assign to Richfield seventy (70) per cent

of all of its right, title, and interest in and to said leases in so far as they affect the lands leased by said Norris lease and said O'Day lease to be so included in said joint lands. Quality shall have the right to consult with and advise Richfield, as Operator, in connection with operations hereunder, but the final determination in all matters shall rest solely with Operator."

"16. Operator will, on or before the last day of the calendar month following the month in which a well on said joint lands is placed on production, render a statement of accumulative joint expenses, and will thereafter, on or before the last day of each calendar month render to Quality a statement of accumulated gross revenues, joint expenses, and net proceeds or net deficit for the preceding calendar month, showing—

(a) All joint expense incurred during the preceding calendar month.

(b) All oil and gas or products derived therefrom shipped from the joint lands by Operator during the preceding calendar month in quantities, quality, and gravity.

(c) All oil and gas, or products derived therefrom, sold and the amount received for the joint account.

(d) The market value of any oil and gas, or products derived therefrom, taken, retained or used by Richfield for its own use (including a statement of the cost of trucking or transportation of the same if the price to be paid Richfield is to be reduced by the amount of such cost).

(e) The proceeds from any sundry sale or service rendered by Operator for the benefit of joint operations hereunder.

(f) All rentals, royalties, and lease payments paid for the joint account.

(g) The net proceeds or net deficit of the joint account, as the case may be."

"22. Title to all buildings, structures, improvements, facilities, equipment, materials and supplies constructed, installed or placed on the joint lands in connection with joint operations hereunder, shall be and remain in Operator and Quality shall have no interest therein, except that Quality shall have the right to have the joint account credited with the value of any thereof removed from the joint account, as provided in the Exhibit "A" hereof. Upon the termination of this agreement as to all or any part of said joint lands, all such buildings, structures, improvements, facilities, equipment, materials and supplies not deemed necessary or convenient by Operator for operations on the part of said joint lands still subject to this operating agreement shall be disposed of and the proceeds divided, as provided for in the Exhibit "A" hereof, upon the basis of seventy (70) per cent thereof to Richfield and thirty (30) per cent thereof to Quality, provided that no such division shall be made until Richfield, as Operator, has been reimbursed for all joint expense incurred by it hereunder, including the cost of abandonment of any and all wells drilled on said joint lands as to which this operating agreement is so terminated."

"24. It is not the intention of the parties hereto to create, nor shall this agreement be construed as creating, a partnership between parties hereto, or to render them liable as partners, and neither of the parties hereto shall be or act as the agent, servant or employee of the other for any purpose whatsoever."

Paragraph 14 lists many different things which Richfield as Operator has the sole and exclusive right to, and shall do, the costs and expenses of which are to be charged to joint expense.

By paragraph 18, Richfield had the right to terminate the agreement at any time as to all or any part of the joint lands, provided, upon any such termination, Richfield was required to quitclaim and/or reassign to Quality all of its right, title and interest in and to said leases in so far as they affect the part of the joint lands as to which the operating agreement is so terminated.

On April 29, 1948, Quality executed another "partial assignment of oil and gas leases" which is in the same form as the prior one and transferred an undivided 70% interest to an additional specified portion of land held by Quality under subleases. Quality retained an undivided 30% interest in the portion of the land covered by the second assignment. The assignment incorporated the operating agreement executed in connection with the prior assignment to Richfield. On the same day the operating agreement was amended to include the additional land.

On July 30, 1948, Quality entered into two contemporaneous agreements with Hancock relating to a different portion of the lands it held under the subleases. The agreements were entitled "PARTIAL ASSIGNMENT OF OIL AND GAS LEASES" and "OPERATING AGREEMENT (carried interest)". They were substantially the same as those entered into between Quality and Richfield except that (1) they applied to a different portion of the land covered by Quality's subleases; (2) the assignment was of a 50% (instead of a 70%) interest with a 50% retained undivided interest; (3) Quality retained a 23½% overriding royalty interest; (4) joint expense, in addition to items similar to those included in the Richfield operating agreement was stated to include $100,000 "in cash as advance royalty hereunder" and the market value of designated steel goods to be delivered to Quality by Hancock, both of which were to be debited to Quality's account and credited to Hancock's account and for which Hancock was entitled to reimbursement out of 36.17% of Quality's 23½% overriding interest and its share of net income; and (5) Hancock's right to its share of oil was stated to be subject to Richfield's right to purchase such oil in accordance with Quality's operating agreement with Richfield.

On June 20, 1949, Quality and Hancock entered into a supplemental agreement amending the operating agreement of July 30, 1948, in certain respects bearing on the sale of oil and gas and stating, in paragraph 1, as follows:

> "Each of the parties hereto is the owner of an undivided one-half of all oil and gas produced and saved from the joint lands and, subject only to said right of Richfield Oil Corporation to purchase all of the oil and gas produced from said joint lands as hereinabove mentioned, each of

the parties hereto has the full right to sell or otherwise dispose of its said one-half of all such oil and gas so produced and saved, and Hancock has no representative authority or capacity to sell or market Quality's one-half share of any part of the oil gas, or other hydrocarbon substances produced from the joint lands."

On December 30, 1949 Richfield entered into a written agreement with Quality, appellee Joseph M. Thomas, and other persons having an interest in the properties being operated by Richfield, (referred to collectively as "Quality"), amend the operating agreement of March 17, 1948 as amended by the agreement of April 29, 1948. Paragraph 1 of the amendment reads as follows:

"1. Quality is the owner of an undivided thirty (30) percent and Richfield is the owner of an undivided seventy (70) percent of the lessee's interest under, and the leasehold estates created by, the oil and gas leases described in said operating agreement hereinafter referred to as 'said leases', in so far as said leases cover the lands described in said operating agreement and therein and hereinafter referred to as 'joint lands' and in the oil, gas and other hydrocarbon substances produced and saved from the joint lands under said leases; except oil, gas and/or other hydrocarbon substances reserved as royalty under said leases, or under oil and gas leases or other agreements to which they are subject, and except such oil, gas and/or other hydrocarbon substances as Operator shall not be required to account for under the provisions of paragraph 10 of said operating agreement but subject to the terms, covenants, and conditions of said operating agreement, and each of the parties hereto has the full right to sell or otherwise dispose of its respective share of all oil, gas and/or other hydrocarbon substances produced and saved from the joint lands under said leases and said operating agreement, except such oil, gas and/or other hydrocarbon substances as are so reserved or as Operator shall not be required to account for under the provisions of paragraph 10 of said operating agreement, and Richfield has no representative authority or capacity under

said operating agreement to sell, mortgage or otherwise dispose of Quality's thirty (30) percent share of the oil, gas or other hydrocarbon substances produced and saved from the joint lands under said leases and said operating agreement, except that Richfield, as operator under said operating agreement, shall have the right to deliver for the account of Richfield and Quality oil, gas and/or other hydrocarbon substances taken or paid in kind as royalty under said leases, or under any oil and gas lease or other agreements to which said leases are subject."

By paragraph 2 of the amendment Richfield agreed to buy, and Quality agreed to sell, its 30% share of all oil, gas and other hydrocarbon substances produced and saved from the joint lands at the market value thereof as defined in the original operating agreement.

Paragraph 3 of the amendment states that Richfield had the right to offset against and deduct from the selling price of such 30% share, Quality's 30% share of all joint expenses as defined in the original operating agreement, incurred prior to the end of the calendar month in which sales were made.

By paragraph 6 of the amendment, paragraph 6 of the original operating agreement was amended to provide that Richfield would pay all expenses and that Quality would be personally liable for its share of such expenses only to the extent of the full amount of the proceeds from the sale by Quality of its share of the oil and gas.

By paragraph 9 of the amendment, paragraph 9 of the original operating agreement was amended to provide that Richfield would pay to Quality, on or before the last day of each calendar month, Quality's share of the proceeds after first deducting and offsetting the latter's share of the expenses.

By other paragraphs of the amendment the original operating agreement was amended to substitute, for references to crediting revenue or income to the joint account, reference to Quality's share of oil or the proceeds from its sale to Richfield.

On the 15th day of July, 1950, appellee Joseph M. Thomas and Richfield entered into a "MODIFICATION AGREEMENT"

under which the operating agreement was modified, so far as the interest of such appellee was concerned, to delete paragraphs relating to the assignment of Quality's interest and substitute a provision, as between Richfield and such appellee, requiring any assignment to be of the parties' entire interest or of equal interests in both leases, but permitting a mortgage or pledge as security for debt.

The above described joint ownership of oil and gas rights under said subleases, and the operating agreements with Richfield and Hancock, as amended, remained in full force and effect through the years 1953 and 1954.

The proceeds from production prior to 1953, from both the Richfield and the Hancock operations, exceeded the cost of development and operation expenses incurred prior to 1953.

The disposition of the depletion issue will automatically dispose of other adjustments summarized in the specification of errors relied upon by appellant since all derive from the lower court's holding as to the depletion allowance. The 50% of net income limitation contained in 26 U.S.C. § 114 is not applicable under the facts before us.

Since the issues arising from the relationship between Quality and Richfield are identical to the issues arising from the relationship between Quality and Hancock, we will hereafter confine our discussion to the relationship existing between Quality and Richfield.

This relationship may be summarized as follows: Under the partial assignments of oil and gas leases made by Quality to Richfield, Quality retained an undivided 30% interest in and to the leases covered by said partial assignments and the estates thereby created. Under the December 30, 1949 amendment to the operating agreement Quality was declared to be the owner of a 30% interest under the leasehold estates, and in and to the oil, gas and other hydrocarbon substances produced and saved therefrom.

Under the original operating agreement Richfield was given the sole and exclusive right to explore for, develop, produce and market oil, gas and other hydrocarbon substances recoverable from

the joint lands. Under the amendment of December 30, 1949, it was agreed that each of the parties [Richfield and Quality] has the full right to sell or otherwise dispose of its respective share of all the oil, gas and other hydrocarbon substances produced and saved from the lands described in the lease, and that Richfield has no representative authority or capacity to sell or otherwise dispose of Quality's 30% share, except that Richfield, as operator, has the right to deliver for the account of both parties oil, gas and other hydrocarbon substances taken or paid in kind as royalty under said leases. Under the amendment Richfield agrees to buy and Quality agrees to sell its 30% share at market value as defined in the original operating agreement.

Under the original operating agreement Richfield was required, in the first instance, to pay all joint expenses and was required to credit to the joint account all gross revenues from operations and charge to the joint account all joint expenses, including the sum of $40,000.00 paid by Richfield to Quality for the interest assigned by Quality to Richfield. The excess of gross revenues over and above the joint expenses is defined as "net proceeds," of which Richfield was entitled to receive 70% thereof and Quality 30% thereof, except that Richfield was entitled to retain, maintain and deduct from Quality's 30% a reserve operating fund of $25,000. Quality was chargeable for interest on the amount of any "net deficit," at the rate of 4% per annum. Quality was not personally liable for joint expenses other than to the extent of its interest in gross revenues and Richfield was required to reimburse itself for joint expenses solely from the joint account. Under the amendment, Richfield has the right to offset against and deduct from the selling price of Quality's 30% share. Quality's 30% share of all joint expenses (including interest on any net deficit) and Quality is to be personally liable for its share of such joint expenses only to the extent of the full amount of the proceeds from the sale of its share of oil and gas. Richfield agrees to pay to Quality Quality's share of such proceeds after deducting and offsetting Quality's share of expenses. References in the original operating agreement to crediting revenue or income to the joint account were changed to references to Quality's share of oil and gas or the proceeds from their sale to Richfield.

The proceeds from production in each of the tax years in question, from both the Richfield and the Hancock operations, exceeded the cost of development and operation expenses incurred in each of said years.

Although the provisions of the Internal Revenue Code of 1939, as amended, are applicable to the tax year of 1953 and the Internal Revenue Code of 1954 is applicable to the tax year of 1954, our references will be to the 1954 Code since the pertinent provisions are, in essence, identical. The applicable provisions of the Internal Revenue Code of 1954 are:

"§ 611. *Allowance of deduction for depletion*

"(a) *General rule.*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions of each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. • • • •.

"(b) *Special rules.*—

"(1) Leases.—In the case of a lease, the deduction under this section shall be equitably apportioned between the lessor and lessee.

"• • • •."

"§ 613. *Percentage depletion*

"(a) *General rule.*—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. • • •.

"(b) *Percentage depletion rates.*—The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

"(1) 27½ percent—oil and gas wells.

"• • • •.

"(c) *Definition of gross income from property.*—For purposes of this section—

"(1) *Gross income from the property.*—The term 'gross income from the property' means, in the case of property other than an oil or gas well, the gross income from mining.

"• • • •"

Treasury Regulations on Income Tax (1954 Code):

"Sec. 1.613-3. *Gross Income From The Property.*

"(a) *Oil and gas wells.* In the case of oil and gas wells, 'gross income from the property', as used in section 613(c)(1), means the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well. If the oil or gas is not sold on the premises but is manufactured or converted into a refined product prior to sale, or is transported from the premises prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price of the oil or gas before conversion or transportation.

"• • • •"

The deduction allowance for depletion is in recognition of the fact that minerals in place are wasting assets and the depletion allowance is designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted the owner's capital is unimpaired. *Helvering v. Bankline Oil Co.*, 303 U.S. 362 (1938); *Kirby Petroleum Company v. Commissioner*, 326 U.S. 599 (1946); *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308 (1956); *Parsons v. Smith*, 359 U.S. 215 (1959)

The depletion allowance under the statute is limited to 27½% "of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. • • •." Such allowance must be equitably proportioned among the parties having economic interests in the oil and gas in place in accordance with their respective interests. *Helvering v. Twin Bell Syn-*

dicate, 293 U.S. 312 (1934); *Commissioner v. Southwest Exploration Co., supra; Parsons v. Smith, supra.*

A taxpayer is entitled to share in the depletion allowance where he has acquired, by investment, any interest in the oil or gas in place, and secured by legal relationship income derived from the extraction of the oil or gas to which he must look for return of his capital. In such case a taxpayer has an "economic interest." *Palmer v. Bender,* 287 U.S. 551 (1933); *Commissioner v. Southwest Exploration Co., supra; Parsons v. Smith, supra.*

The allowance for depletion is not made dependent upon the particular legal form of the taxpayer's interest in the property to be depleted. *Palmer v. Bender, supra.*

> "Economic interest does not mean title to the oil in place but the possibility of profit from that economic interest dependent solely upon the extraction and sale of the oil." *Kirby Petroleum Co. v. Commissioner, supra,* p. 604.

See also: *Commissioner v. Southwest Exploration Co., supra; Burton-Sutton Oil Company v. Commissioner,* 328 U.S. 25 (1946).

The critical question presented by this appeal is whether the appellees for the tax years in question, have an economic interest in the working interest[1] of the leases so as to entitle them to use as a base for the computation of their depletion allowance a proportionate share of gross revenues from the leased lands.

The appellant and the amici oil companies recognize that the appellees have a legal interest or property right in the oil and gas in place under the reserved and retained rights of Quality, and concede that appellees have an economic interest in the oil and gas in place sufficient to support depletion on the proceeds from the sale of oil and gas received by them. They contend that such is the limit to appellees' right of depletion and compare such right to a "net profits" interest[2] in the oil and gas in place. A net profits interest is deemed to be an economic interest in the oil and gas in place. *Kirby Petroleum Co. v. Commissioner, supra.* See *Burton-Sutton Oil Co. v. Commissioner, supra; Commissioner*

[1]Mineral interests minus royalty interests.

[2]A share of gross production measured by net profits from the operation of the property.

v. Southwest Exploration Co., supra; Grandview Mines v. Commissioner, 282 F.2d 700 (9th Cir. 1960); *Commissioner v. Felix Oil Co.*, 144 F.2d 276 (9th Cir. 1944).

Appellees contend they have a "carried interest" in the oil and gas in place.[3]

In support of such contention appellees rely on the following cases: *Reynolds v. McMurray*, 60 F.2d 843 (10th Cir. 1932) C.D. 287 U.S. 664; *Helvering v. Armstrong*, 69 F.2d 370 (9th Cir. 1934); *T. K. Harris Company v. Commissioner*, 112 F.2d 76 (6th Cir. 1940); *Commissioner v. J. S. Abercrombie*, 162 F.2d 338 (5th Cir. 1947); *Prater v. C.I.R.*, 273 F.2d 124 (5th Cir. 1959).

While the legal relationship between Richfield and Quality, viewed from the standpoint of property law concepts is, in form, that of co-owners of the working interest in the leases involved, the Supreme Court in the cases above cited has made it clear that legal title and property law concepts alone are not determinative of the party who has an economic interest in the working interest. In the area of taxation economic realities determine tax consequences.

Under the operating agreement as amended: Richfield was placed in sole and exclusive control of the property; Richfield was obligated throughout the term of the relationship to furnish, in the first instance, all capital for exploration, development and operation of the property; Richfield retained full title to all tangible property; Quality was under no personal obligation to contribute to or bear any portion of such expenditures; Richfield was required to look solely to production proceeds for recoupment of all expenditures, and alone bore the risk and burden if proceeds from production failed to equal expenditures; and Richfield alone benefits from the recoupment of expenditures through

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[3]An arrangement between two or more co-owners of a working interest, whereby one agrees to advance all or some part of the development costs on behalf of the others, and to recover such advances from future production, if any accruing to the other owners' share of the working interest. See *Estate of H. H. Weinert, et al. v. Commissioner*, 294 F.2d 750 (5th Cir. 1961).

production since Quality was under no personal obligation in respect to expenditures.

In our view the substance and effect of the legal arrangement between Richfield and Quality is that Quality assigned to Richfield, at the beginning of the legal relationship, so much of Quality's oil and gas in place as would be needed during the term of that relationship to reimburse Richfield for Quality's portion of the development and operating expenses, and thus retained not an economic interest in the working interests of the leases but in reality only a "net profits" interest. The fact that the proceeds from production in the years in question exceeded the cost of development and operation expenses incurred during those years does not alter the fact that Richfield bore the risk and burden of Quality's share of the expenditures and looked solely to production for recoupment.

We concede that the holdings in the cases relied upon by appellees support their contentions.

The holdings in *McMurray*, *Armstrong* and *Harris* are based primarily, if not wholly, upon property law concepts, and the opinions in those cases give no consideration to the "economic interest" concept as developed in many of the Supreme Court cases above cited. Likewise *Abercrombie* and *Prater* rely upon property law concepts and resort to legal fictions which were severely criticized by a recent decision of the same Circuit,[4] and their precedential value was largely undermined.

We are in no position to overrule any of the cases relied upon by appellees except the *Armstrong* case. We believe that the vitality of that case has been sapped by the above cited decisions of the Supreme Court and we expressly overrule the decision in *Armstrong*.

The judgment of the District Court is reversed.

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[4]*Estate of H. H. Weinert, et al. v. Commissioner, supra.*

CHAMBERS, Circuit Judge, dissenting:

I would affirm.

Before Southwest Exploration, 350 U.S. 308, I would have unhesitatingly concurred in the foregoing opinion.

In this field of depletion we deal with a deduction that has only an occasional accidental relation to the cost of or investment in a wasting asset. The justification for this special consideration is said to be that we must do it to encourage the risk taking necessary to make and keep our country big and strong. I am not wise enough (and it is none of our business) to condemn the law. As a citizen, I think I would favor something like the present law.

But believing that the purpose of the depletion provisions of the Internal Revenue Code was to encourage the man (or the company) to put his money in the hole in the ground was what led me to concur in our opinion in Commissioner v. Southwest Exploration Co., 220 F.2d 58, in favor of the oil company which did the drilling to the exclusion of him with no oil but who had an access road and the onshore drilling site to reach the offshore oil. But I was wrong.

To me, the Quality Oil (the Thomases) interest as a speculator gave it the same percentage of economic interest in the oil as if it (or they) had been personally liable for development and operating costs. Thus, I would not hold the Thomases down to depletion on their net profits, but would let them share the depletion on the difference between the net profit and the gross profit.

If I am wrong again, and that is the evidence today, I am not unhappy with the majority's result.

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In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 113

JOSEPH M. THOMAS and JILL G. THOMAS,
PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The memorandum and order of the district court (R. 36-39) are reported at 205 F. Supp. 194. Its findings of fact and conclusions of law (R. 44-52) are not reported. The opinion of the court of appeals (Pet. App. 1-18)[1] is reported at 329 F. 2d 119.

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[1] "Pet. App." references are to Appendix B to the petition.

JURISDICTION

The judgment of the court of appeals was entered on March 12, 1964. (R. 136.) A petition for rehearing was denied on April 14, 1964. (R. 137.) The petition for a writ of certiorari was filed on May 22, 1964. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the court below erred in holding that the taxpayers' interests in oil and gas properties were net profits interests, rather than leasehold interests, for percentage depletion purposes.

STATUTES INVOLVED

Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.):[2]

> SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.
>
> (a) *General Rule.*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion * * *.
>
> * * * * *
>
> SEC. 613. PERCENTAGE DEPLETION.
>
> (a) *General Rule.*—In the case of the mines, wells, and other natural deposits listed in sub-

[2] Sections 23(m) and 114(b) of the Internal Revenue Code of 1939, applicable to the taxable year 1953, are substantially the same as the quoted sections of the 1954 Code.

section (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. * * *.

(b) *Percentage Depletion Rates.*—The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 27½ percent—oil and gas wells.

* * * *

STATEMENT

The Quality Oil Company was the sublessee of certain oil and gas leases. In March 1948, it assigned a 70% undivided interest in the leases[1] to the Richfield Oil Corporation subject to an "Operating Agreement" under which Richfield, designated as the "operator" of the property, was to finance the development of the property and market the production. The gross revenues were to be credited to a "joint account" from which all the development and operating expenses were first to be paid (including reimbursement of Richfield for its expenditures) and the balance, defined as the "net proceeds," was to be distributed 70%

[1] The March 1948 transaction in fact covered only a part of the area of the leases. Assignments of additional areas were made to Richfield in April 1948 and to the Hancock Oil Company in July 1948 (Pet. App. 9-10). All of the transactions were substantially identical, however, and for simplicity we will treat the case as involving a single assignment.

to Richfield and 30% to Quality.[4] Quality was not personally liable for any expenses incurred, and for recovery of the amounts expended by it for development and operation Richfield could look to the production from the property (Pet. App. 2-8).

In 1949, the operating agreement was amended to declare Quality the "owner" of 30% of the oil and gas produced and to provide that each party could sell its share of the production. Quality was to be liable for expenses only to the extent of the proceeds from the sale of its share of production. It was further provided that Quality would sell its share of the production to Richfield at the going market price and that Richfield could withhold 30% of the expenses from the price paid (Pet. App. 10-11).

Quality subsequently assigned to petitioners one-third of its retained interest in the properties. In each of the taxable years 1953 and 1954, the proceeds from production exceeded expenses, and petitioners accordingly received 10% of the net proceeds. In their income tax returns for those years, petitioners included only the *net* proceeds in their gross income, claimed no deductions for expenses, and claimed a percentage depletion deduction based only on the net proceeds received. In this action, petitioners seek a refund based upon the inclusion in their

[4] Richfield purportedly paid Quality $40,000 for the assignment, but by the terms of the agreement that amount was required to be deposited to the joint account for use for development. That payment was, therefore, no different in substance from the other amounts expended by Richfield for the development of the property.

gross income of the *gross* proceeds from the sale of 10% of the production, a deduction for 10% of the expenses of production, and a percentage depletion deduction based on the gross, rather than the net, proceeds from production. Since including the gross proceeds and deducting the expenses produces, in the circumstances of this case, the same result as including only the net proceeds (as originally reported), the only issue of practical importance is the computation of the percentage depletion deduction—*i.e.*, whether the petitioner's "gross income from the property" (the basis on which percentage depletion is computed, § 613(a)) consists of (a) the net proceeds payable to them by Richfield under the operating agreement or (b) the gross proceeds from the production prior to the payment of expenses. The court of appeals, reversing the district court, denied the increased depletion deduction, holding that in economic substance petitioners had only a "net profits" interest in the property rather than a share of the gross production (Pet. App. 16-18).

ARGUMENT

1. It is well settled that the income derived from the production of oil and gas, and the allowance for percentage depletion computed thereon, must be allocated among the parties to the production venture in proportion to their respective economic interests in the minerals in place. In the present case, the court below properly held that petitioners' interest, though in form a leasehold (or working) interest, was in

economic substance merely an interest in the net profits of the production.[5] Under the terms of the assignment and operating agreement between Richfield and Quality (the petitioners' assignor), Richfield was given exclusive control of the property; was obligated to provide, in the first instance, all capital for exploration, development and operation throughout the term of the relationship; was required to look solely to the production proceeds for recoupment of its expenditures, and thus alone bore the risk and burden if those proceeds failed to match expenditures; and alone stood to profit from the recoupment of expenditures through production, since Quality was not personally liable. Conversely, Quality had no control over the operation; was under no personal obligation to bear any portion of the expenditures; and looked for its reward solely to the net profits of production after Richfield's expenditures had been recouped. Thus, the economic substance of the transaction was that Quality transferred to Richfield the burdens and benefits of its working interest in the

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[5] The leasehold or working interest is the entire interest in the mineral less the customary royalty interest retained by the landowner executing the lease. The owner of the working interest has control over production and liability for all the costs and expenses of operation and production. A royalty interest is a right to receive a specified percentage of all oil and gas produced during the term of the lease which is free and clear of the expenses of operation and production for which the leasehold owners are liable. A net profits interest, as the name implies, is a right to receive a fraction of the leasehold owners' net profit from production. Breeding and Burton, *Income Taxation of Oil and Gas Production* (1961 ed.), Secs. 1.07, 2.03, 2.04, 2.06, 3.02.

property, while reserving a fractional participation in the net profits. Accordingly, the Ninth Circuit correctly concluded that the petitioners' basis for depletion must be measured by the net, and not by the gross, profits of production. The fact that petitioners retained legal title to a portion of the leasehold is not controlling; for, as this Court has frequently held, the right to depletion is governed by economic realities and not by the concepts of property law (*e.g.*, *Palmer* v. *Bender*, 287 U.S. 551). And, legal ownership aside, Quality was in precisely the same position as the taxpayer in *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599, who was concededly the owner of a net profits interest.[6]

2. While the decisions in this area have not been consistent, there is, we believe, no present conflict of views among the circuits requiring resolution by this Court.

The Sixth Circuit's decision in *T. K. Harris Co.* v. *Commissioner*, 112 F. 2d 76, is distinguishable. There the taxpayer, who owned real property, entered into an agreement with a gas company whereby the latter was to drill wells on the property at its own expense and to be reimbursed out of gas production. When the costs had been recovered, the wells were to become the property of the taxpayer, and the gas company was to continue operating the wells on specified terms and to buy the output. Thus, the gas company, un-

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[6] See also *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25; *Commissioner* v. *Southwest Expl. Co.*, 350 U.S. 308; *Grandview Mines* v. *Commissioner*, 282 F. 2d 700 (C.A. 9); *Commissioner* v. *Feli. Oil Co.*, 144 F. 2d 276 (C.A. 9).

like Richfield in the present case, had neither a legal interest in the property nor an equity interest in the production enterprise, except as a source from which to recoup its initial drilling costs; thereafter its dual role was that of an independent contractor performing services for a fee and a purchaser of the mineral product. In those circumstances, it would have been difficult to hold that the gas company had a taxable and depletable interest in the minerals in place. Instead, the Sixth Circuit held that the gas proceeds which were credited to the taxpayer's account on the company's books and applied toward reimbursement of its drilling costs constituted income to the taxpayer used by him to purchase the completed wells. Such a rationale would be impossible on the facts of the present case, and it is significant that the Sixth Circuit's approach is not the one urged by the taxpayer here.

Reynolds v. *McMurray*, 60 F. 2d 843 (C.A. 10, 1932), certiorari denied, 287 U.S. 664, although admittedly inconsistent with the decision below, is an old case whose reasoning has been outmoded by subsequent decisions of this Court. In that case, involving a fact situation substantially identical to the one here, the Tenth Circuit held that the taxpayer was taxable (and therefore entitled to depletion) on his share of the production receipts which went to reimburse the other leasehold owner for the expenses of development and operation he had advanced. But the decision rested chiefly on the ground that the taxpayer had retained legal title to the leases. Later, this Court established the principle that the taxability of

income from mining, and the right to depletion thereon, do not depend upon legal title, but upon the realistic economic interests of the mining venturers. *Palmer* v. *Bender*, 287 U.S. 551 (1933); *Kirby Petroleum Company* v. *Commissioner*, 326 U.S. 599 (1946); *Burton-Sutton Oil Company* v. *Commissioner*, 328 U.S. 25 (1946). In light of these supervening decisions, it is doubtful that the Tenth Circuit would adhere to *Reynolds* if the issue were now presented to it.

While *Commissioner* v. *J.S. Abercrombie Co.*, 162 F. 2d 338 (C.A. 5), is also at odds with the decision below, its authority has been greatly undermined by the Fifth Circuit's subsequent decision in *Weinert's Estate* v. *Commissioner*, 294 F. 2d 750. In the latter case, the court held (p. 755) that "the tax concept of 'economic interest' and not the common law concept of title must control the division of taxable income in the development and operation of oil and gas property" and hence that production receipts used to reimburse the "carrying party" for his outlays of expenses are taxable to him and not to the "carried party."[7] To be sure, the court did not ex-

[7] A "carried interest" has been defined as "an arrangement between two or more co-owners of a working interest, whereby one [the carrying party] agrees to advance all or some part of the development costs on behalf of the others [the carried parties] and to recover such advances from future production, if any, accruing to the other owners' share of the working interest." Breeding & Burton, *Taxation of Oil and Gas* (1961 ed.), Sec. 2.08; Pet. 17; *Weinert's Estate*, *supra*, 294 F. 2d 750. In referring to the carrying party's outlays as "advances * * * on behalf of" the carried parties, that defini-

plicitly overrule *Abercrombie*, but distinguished it on the dubious ground that there the taxpayer had retained legal title to the leasehold, whereas in *Weinert* the taxpayer had conveyed title to a trustee for the period of the pay-out. But the court stressed (pp. 756-757) that "the statements in [*Abercrombie*] emphasizing the common-law concept of ownership tend to weaken the tax concept of economic interest" and that *Abercrombie* must be narrowly interpreted. In addition, it cited, and impliedly endorsed, the existing administrative practice whereby the Service had so drastically limited the application of *Abercrombie* that, in the words of one commentator, "it would not be surprising if the Service were to refuse to apply the Abercrombie principle to an exactly similar factual situation unless the taxpayer's name were also J. S. Abercrombie Co." 294 F. 2d 757, fn. 14 (quoting Peck, *Recent Developments in Oil and Gas Taxation*, 10th Ann. Inst. on Oil and Gas Tax (S. W. Legal Fdn. 1959) 421). In light of those comments, and the express rejection of the rationale upon which *Aber-*

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tion might be thought to resolve in petitioners' favor the very question which is at issue here. Thus, the court below regarded as a point of contention whether petitioners in fact had a "carried interest" in the oil and gas in place (Pet. 17), and concluded that they did not. The "carried interest" terminology has, however, sometimes been used by commentators to describe the general type of arrangement involved in this case, without thereby implying any conclusion as to the tax consequences. While we have no objection to petitioners' use of the phrase, in this neutral sense, to refer to the arrangement here, we do not concede, of course, that Richfield's payments for expenses were advances or loans to Quality.

crombie, was decided, it appears that the Fifth Circuit's current position on this issue is in substantial accord with that of the court below, and that *Abercrombie* might now be overruled if a case on all fours with it were presented to the Fifth Circuit.

While the issue is undoubtedly important to the oil and gas industry, the applicable legal rules are sufficiently well-established that there is no need for review by this Court. At the administrative level, as we have noted, the Service has long ruled that, during the pay-out period (or, as here, during the life of the lease) the income which goes to reimburse the operator for the drilling and operating expenses he has incurred is taxable to (and depletable by) him, and not to the other leasehold owner who bears no risk; that *Reynolds* v. *McMurray*, *supra*, should not be followed; and that *Abercrombie* should be so narrowly applied as virtually to deprive it of any precedential value. G.C.M. 22739, 1941-1 Cum. Bull. 214, 223-224; *Weinert's Estate* v. *Commissioner*, *supra*, p. 757, fn. 14. The decision below merely confirms this settled administrative practice. Arrangements of the type involved here are commonplace in the oil and gas industry, and hundreds, if not thousands, of tax returns have been filed by the parties to such arrangements. Yet, so well accepted and widely understood has the Service's position been that the issue presented

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Prater v. *Commissioner*, 273 F. 2d 121 (C.A. 5), also cited by petitioners, was decided on the basis of *Abercrombie* and before *Weinert*. *Sowell* v. *Commissioner*, 302 F. 2d 177 (C.A. 5), dealt with an altogether different issue.

here has arisen in only a small handful of cases over the course of thirty years. We are advised by the Service that an informal review within the national office discloses no pending case in which a taxpayer having a net profits interest such as petitioner's has reported as income, or claimed the related deductions upon, an amount equal to "his" share of the expenses. Thus, unless there should emerge a live conflict among the circuits, we submit that there is no occasion for intervention by this Court.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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JULY 1964.

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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1964

No. 113

JOSEPH M. THOMAS and
JILL G. THOMAS,
Petitioners,

vs.

UNITED STATES OF AMERICA,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

PETITION FOR REHEARING OF PETITION FOR A WRIT OF CERTIORARI

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Petitioners Present Their Petition for a Rehearing of this Court's Order Dated October 12, 1964, denying the Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit, and, in support thereof, respectfully show:

The Petition for a Writ of Certiorari herein was denied by Order of this Court on October 12, 1964. On the same date the Petition for a Writ of Certiorari was granted in *Paragon Jewel Coal Company, Inc., v. Commissioner of Internal Revenue*, 330 F(2d) 161 (4th Cir. 1964) (See Appendix hereto).

GROUNDS OF PETITION FOR A WRIT OF CERTIORARI

The Petition for a Writ of Certiorari filed herein was based upon the following grounds:

(1) The decision of the Court of Appeals for the Ninth Circuit is admittedly in direct conflict with the decision of the Court of Appeals for the Tenth Circuit in *Reynolds v. McMurray*, 60 F(2d) 843, the decision of the Court of Appeals for the Sixth Circuit in *T. K. Harris Company v. Commissioner*, 112 F(2d) 76, and the decisions of the Court of Appeals for the Fifth Circuit in *Commissioner v. J. S. Abercrombie Co.*, 162 F(2d) 338 and *Prater v. Commissioner*, 273 F(2d) 124.

(2) This case involves an important question of federal law which has not been, but should be, settled by this Court.

GROUNDS OF PETITION FOR REHEARING

This petition for rehearing is based upon the ground that the basic issues involved in the present case are the same as the basic issues involved in *Paragon Jewel Coal Company, Inc., v. Commissioner*, 330 F(2d) 161 (4th Cir. 1964), in which the petition for a

writ of certiorari was granted on October 12, 1964, that the review of the *Paragon* case by this Court will necessarily involve consideration of the issues in the present case and that a reversal of the decision of the Court of Appeals for the Fourth Circuit in the *Paragon* case would require disapproval by this Court of the principles applied by the Court of Appeals for the Ninth Circuit in the present case.

COMPARISON OF THE FACTS AND ISSUES OF THE PRESENT CASE AND THE PARAGON CASE

In the present case, petitioners' predecessor, Quality Oil Company, owned the entire working interest under an oil lease. Quality assigned a 70% interest in a portion of the lease to Richfield Oil Company, and at the same time the parties entered into an operating agreement under which Richfield was given the right to develop and operate the property. Richfield was required to advance the costs of development and operation and Quality was required to pay 30% of such costs, but its liability was limited to the proceeds from its share of the oil produced.

The operating agreement expressly provided that Quality was the owner of an undivided 30% and Richfield was the owner of an undivided 70% of the leasehold estate, and the oil and gas produced and saved, that each party had full right to sell or otherwise dispose of its share of the oil and gas and that Richfield had no authority to sell or otherwise dispose of Quality's share of the oil and gas produced and saved.

Quality agreed to sell its share of the oil and gas to Richfield at the market price.[1]

The property was successfully developed and the oil produced prior to the years at issue was more than sufficient to pay all exploration and development costs and operating expenses.

The issue involved is whether that portion o the proceeds received from the sale of petitioners' share of the oil which Richfield, as operator, applied in payment of petitioners' share of the operating expenses constituted gross income to petitioners for purposes of depletion or whether said portion of the proceeds should be added to Richfield's gross income for depletion purposes.[2]

In reversing the decision of the District Court, the Court of Appeals for the Ninth Circuit determined that, in spite of the express agreement between the parties with regard to their respective interests in the lease and in the oil produced, Quality in substance and effect assigned to Richfield so much of Quality's share of the oil and gas in place as would be needed to reimburse Richfield for Quality's share of the expenses. (Pet. Cert. App. p. 18.)

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[1]There was a similar partial assignment to and operating agreement with Hancock Oil Company of another portion of the leased property.

[2]Both parties agree that Richfield's gross income from the property included the gross proceeds from its full 70% after land owner's royalties and that Petitioners' gross income from the property was not less than their share of the net proceeds after deduction of all development and operating expenses. The dispute is whether the portion of the gross proceeds which was applied in satisfaction of Petitioners' share of the expenses was gross income to Petitioners or to Richfield.

The Court of Appeals also emphasized that Richfield bore the risk since it was required to advance the development and operating expenses and was to be reimbursed from the proceeds of the oil produced and apparently concluded that the party who bears the risk is entitled to the depletion regardless of who owns the oil.[3] (Pet. Cert. App. pp. 17, 18.)

In *Paragon Jewel Coal Company v. Commissioner*, supra, Paragon owned the working interest in a coal lease and entered into oral agreements with several operators to mine the coal from designated areas and deliver the coal to Paragon. The operators furnished their own equipment and paid their own operating expenses and were paid by Paragon at a specified rate per ton of coal delivered to Paragon.

The issue presented was whether the operators had an economic interest in the coal in place and were entitled to a deduction for depletion based upon the payments which they received from Paragon or whether Paragon retained the economic interest in the coal in place and was entitled to compute its gross income from the property, for depletion purposes, without reduction for the payments to the operators.

The Court of Appeals for the Fourth Circuit determined that the investments of the operators in equipment and in the production of the coal gave them the right to mine the property to exhaustion and that this right together with their investment

[3]During the years at issue the risk was entirely theoretical since the production greatly exceeded the costs of production.

of time and money gave them an economic interest in the coal in place and gave them the right to depletion based upon the payments which they received for the coal produced and delivered.

While the opinion of the Court does not expressly so state, it is apparent that the rationale of the decision of the Court of Appeals in the *Paragon* case is that a party who expends funds for the development or production of a mineral and must look to the mineral produced for the recovery of such expenditures and thereby assumes the risk that production may not be sufficient to pay the expenses has an economic interest in the mineral in place which is subject to depletion and that the payments which such party receives for producing and delivering the mineral is his gross income from the property for depletion purposes.

The material facts in the present case and in the *Paragon* case are basically identical. Richfield had no actual ownership of any portion of Petitioners' share of the oil in place and the Paragon operators had no actual ownership of any of the coal in place. Both Richfield and the Paragon operators incurred the expense and took the risk involved in producing the mineral. Neither Richfield nor the Paragon operators acquired ownership of the mineral produced as the result of the production.[4] Both Richfield and

[4]Richfield owned 70% of the oil because of its 70% interest in the lease and Richfield had the right to purchase Petitioners' entire share of the oil produced but did not acquire title to any part of Petitioners' share except by purchase.

the Paragon operators were dependent upon production for recovery of the expenses incurred by them.

The basic issue in both cases is whether the assumption of the risk and the expense of producing minerals which belong to another party gives the party who assumes such risk and expense an economic interest in the mineral in place and whether the compensation or reimbursement received by the party who assumes the risk and expense constitutes "gross income from the property" to such party or to the owners of the mineral produced, for depletion purposes.

The decisions of the Courts of Appeal in both cases are based upon principles which are contrary to the decision of this Court in *Parson v. Smith,* 359 U.S. 215 (1959), in which operators of coal property who assumed the expense and risk of production and were compensated on the basis of production were denied a deduction for depletion on the ground that they did not have an economic interest in the mineral in place.

Since the material facts and the basic issue in the present case are the same as the material facts and the basic issue in the *Paragon* case, it is respectfully submitted that the two cases should be heard and decided together in order to avoid further confusion in this very important field of law.

CONCLUSION

For the foregoing reasons it is respectfully urged that this petition for a rehearing be granted, and that, upon further consideration, a writ of certiorari issue to the United States Court of Appeals for the Ninth Circuit.

Respectfully submitted,

BAYLEY KOHLMEIER,
Counsel for Petitioners.

November, 1964

I, Bayley Kohlmeier, Counsel for Petitioners, hereby certify that the foregoing Petition for Rehearing is presented in good faith and not for delay and that it is restricted to the grounds specified in Rule 58, Subdivision 2, of the Rules of this Court.

BAYLEY KOHLMEIER,
Counsel for Petitioners.

(Appendix Follows)

Appendix

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 9179.

Robert Lee Merritt and Winnie Merritt;
G. Wesley Merritt and Fannie J. Merritt;
Jack D. Merritt and Willa Gray Merritt;
Virginia Bowling and Gladys Bowling, and
James O. Watson, 3rd, and Lucy J. Watson,
Petitioners,

versus

Commissioner of Internal Revenue
Respondent,

and

Commissioner of Internal Revenue,
Petitioner,

versus

Paragon Jewel Coal Company, Inc.,
Respondent.

ON PETITIONS TO REVIEW THE DECISIONS OF THE TAX COURT OF THE UNITED STATES.

(Argued January 13, 1964. Decided March 17, 1964.)

Before HAYNSWORTH, BRYAN and J. SPENCER BELL, Circuit Judges.

John Y. Merrell for Petitioners, Taxpayers; Michael Mulroney, Attorney, Department of Justice, (Louis F. Oberdorfer, Assistant Attorney General, and Lee A. Jackson and Melva M. Graney, Attorneys, Department of Justice, on brief) for Commissioner of Internal Revenue, and Frederick Bernays Wiener (Leroy Katz and Carl C. Gillespie on brief) for Respondent, Paragon Jewel Coal Co., Inc.

J. SPENCER BELL, Circuit Judge:

These are consolidated appeals from the Tax Court. The issue is whether the lessee, Paragon Jewel Coal Company, Inc. [hereinafter referred to as Paragon], is entitled to the entire depletion deduction on the coal mined from its leased property or whether the several contract mine operators, petitioners in this action [hereinafter referred to as the operators], are entitled to a part of that depletion deduction based upon the amounts received by them respectively for the coal which each of them mined under agreements with Paragon. The Tax Court, which heard the cases together, decided that the lessee, Paragon, was en-

titled to the entire percentage depletion deduction. The operators appeal, contending that Paragon is required to share the deduction with them. The Commissioner, who took a neutral position as between the petitioners and Paragon before the Tax Court, appeals the decision in Paragon's case in order to protect his position as a stakeholder, conceding that either the operators or the lessee is entitled to the deduction, but not both.

Since the Commissioner concedes that either the operators or the lessee, Paragon, is entitled to the deduction, we find it unnecessary to go into all of the factual background, but shall confine ourselves to that part which we consider relevant to a decision of the issue between the parties. Paragon is the assignee of certain leases of coal bearing lands under which it has paid minimum royalties, tonnage royalties and land taxes. It has made substantial investments on the properties in order to prepare itself to process, ship and market the coal which was produced. Paragon's experience was as a processor and seller of coal rather than a producer; furthermore it lacked the capital to go into the producing end of the business. Rather than mine the coal itself, it entered into oral agreements with the petitioning operators and others to mine the coal by a method known as drift mining.[1] In addition to the equipment necessary

[1]Drift mining is done by driving a horizontal shaft into the hillside in order to extract the coal from seams which are usually less than three feet in thickness. The process is a difficult and economically marginal operation.

for storing and processing the coal, Paragon installed a road running around the mountain close to the outcrop line of the coal over which the coal could be trucked from the mines to Paragon's tipple, where Paragon cleaned, sized and sold the coal.

Beginning with the Stilwells in 1951 (who are not petitioners here), Paragon entered into oral leases with a number of operators, all of which were similar in terms. Under the agreement an operator would be allocated a specific surface area under which it might mine. The allocation was made either by pointing it out on the ground or by showing it to him on the over-all property map. The operator agreed to mine the coal within that area and deliver it to Paragon at the operator's own expense. All expenses of opening and operating the mines were borne by the several operators. Paragon agreed to pay a fixed price at the tipple, but it was understood that the price would, and in fact it did, vary with the market. The operators were required to use and pay for the services of Paragon's engineer and to operate and maintain their mines in accordance with state and federal regulations. The contracts were silent as to who was entitled to depletion. They contained no termination date and nothing was said between the parties on this subject. The Tax Court found that:

> It was anticipated by both parties that a contractor [contract mine operator] would continue mining in the location assigned to him as long as the coal could be mined and sold at a profit and as long as the contractor employed proper

mining methods and produced coal meeting Paragon's specifications.

Because the contracts did not contain a specific statement that they were *not* terminable at the will of Paragon and because they did not contain a specific statement that the operator had a right or obligation to mine to exhaustion, the Tax Court concluded that as a matter of law the operators did not under the contracts have such rights.

We must disagree with the Tax Court's conclusions of law. Its own findings as to the intent of the parties quoted above negates its conclusions as to the legal rights of the parties under the contract. The parties contemplated that the operators would, and the evidence shows that they did, engage in large expenditures of time and money in preparing their respective sites for mining. We think the Tax Court was in error in concluding that because the oral contracts were silent on the point, the operators did not possess a non-terminable *right* to mine to exhaustion, especially in the face of the court's finding of an intent on the part of the parties to the contrary. It would be inequitable indeed to hold that Paragon might remain silent on this point until the operators had invested their time and money and then take the benefit of the operators' efforts at will and without cause. The burden was on Paragon to express the limitation, if any. *Jack's Cookie Co. v. Brooks,* 227 F.2d 935 (4 Cir. 1955), *cert. denied,* 351 U.S. 908 (1956). Paragon was under obligation to mine the

property. These operators were performing Paragon's obligation under its leases and this constituted ample consideration running from the operators to Paragon to make their mutual intentions with respect to the contract binding on Paragon. The fact that the contracts did not fix upon the operators an *obligation* to mine to exhaustion does not vitiate the binding effect of the intent of the parties to vest in the operators a *right* to mine to exhaustion. That the operators could cease mining would not destroy the mutuality. *Phillips Petroleum Co. v. Buster,* 241 F.2d 178 (10 Cir.), *cert. denied,* 355 U.S. 816 (1957).

Thus we see under this interpretation of the contracts, the operators had a continuing right to produce the coal and to be paid therefor at a price which was closely related to the market price. By virtue of these contracts and their respective expenditures under them, the operators shared with Paragon an economic interest in the mineral which brings them within the rationale of *Parsons v. Smith,* 359 U.S. 215 (1959); *Elm Dev. Co. v. Commissioner,* 315 F.2d 488 (4 Cir. 1963); and *Stilwell v. United States,* 250 F.2d 736 (4 Cir. 1957).[2] The Tax Court's decisions are reversed and the cases remanded for entry of an order in conformity with this opinion.

Reversed and Remanded.

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[2]Indeed the *Stilwell* case arose out of the same facts, although of course the record being different, it is not *res judicata.*